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No. 96-591

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

VEREX ASSURANCE, INC.,
Petitioner,

v.

NANCY ABSHIRE PALMA,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE AND BRIEF AMICUS CURIAE OF MORTGAGE INSURANCE COMPANIES OF AMERICA IN SUPPORT OF THE PETITION

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MOTION FOR LEAVE TO FILE BRIEF AMICUS CURIAE

Pursuant to S. Ct. Rule 37.2, Mortgage Insurance Companies of America ("MICA") moves for leave to file the attached brief amicus curiae in support of the petition. Petitioner has consented to the filing of this brief. Respondent has not consented, necessitating this motion.

MICA is the trade association representing the private mortgage guaranty insurance industry. Founded in 1973, MICA is composed of eight private mortgage guaranty insurance companies.[1] Collectively, MICA's members

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[1] These companies and their affiliates comprise the United States private mortgage guaranty insurance industry: Amerin Guaranty Corporation, Commonwealth Mortgage Assurance Co., General Electric Mortgage Insurance Corporation, Mortgage Guaranty Insurance Corporation, PMI Mortgage Insurance Co., Republic Mort-

write all of the private mortgage guaranty insurance in the United States, insuring millions of mortgage loans and thousands of mortgage lenders and secondary market investors in real estate mortgages. The vast majority of these loans are purchased by such secondary mortgage market agencies as the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Federal National Mortgage Association ("Fannie Mae").

MICA strives to promote a competitive and solvent mortgage guaranty insurance industry, which lends stability to insured lenders in the primary and investors in the secondary mortgage markets. MICA achieves this purpose by educating members and their insured lenders on legislative, regulatory and legal developments impacting the mortgage and mortgage guaranty insurance industries. MICA also serves as a liaison to housing trade organizations and other mortgage industry organizations.

MICA's members [2] believe that the issues presented in the decision below have broad implications for mortgage insurers, their insured lenders and investors in the secondary mortgage market.

The Fifth Circuit's conclusion below that the borrower is a third-party beneficiary of the mortgage guaranty insurance policy negatively impacts millions of insured loans and thousands of mortgage lenders nationwide, despite the fact that such holding is contrary to settled Texas law and that of other jurisdictions. This third-party beneficiary holding creates the exact conflict of interest between insurer and insured—the lender—that the Texas Supreme Court expressly sought to avoid in *Allstate Ins. Co. v.*

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gage Insurance Co., Triad Guaranty Insurance Corporation and United Guaranty Corporation.

[2] Although petitioner was a former member of MICA, GE Capital Mortgage Corporation acquired petitioner in 1993. Petitioner is no longer writing mortgage guaranty insurance and is no longer an active member of MICA.

Watson, 876 S.W.2d 145 (Tex. 1994). Ironically, the majority's *Erie* analysis below relies primarily upon, but misinterprets, *Allstate*.

The decision below illogically seeks to protect the borrower—the very *risk or hazard* against which the mortgage guaranty insurers' customers—the lenders—seek protection in obtaining mortgage insurance. That decision encourages borrower default by leading borrowers to conclude that they may assert provisions in the mortgage guaranty insurance policy to prevent the lender from taking a deficiency against them. This result is detrimental to insured lenders, insurers and the secondary mortgage market. Moreover, a practical effect of the opinion below may be to convert certain Texas borrowers' full recourse notes secured by first liens on real estate into "non-recourse" notes, dramatically reducing the borrowers' incentive to repay the insured mortgage. This reduced incentive increases the risk of borrower default, which weakens both the primary and secondary mortgage markets. Similarly, the decision will result in increased losses to mortgage lenders and insurers on each defaulted loan, since another effect of the Fifth Circuit's opinion is to impair the ability of lenders and their insurers to mitigate losses arising under the particular form of policy at issue in this case.

The Fifth Circuit's effort to reach a particular result by creating new state law is apparent in its opaque analysis under *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938). The inaccuracy of the majority's "*Erie* guess" has now been confirmed by a recent intermediate Texas court decision, *First Am. Title Co. v. Willard*, No. 12-93-00290-CV, 1996 WL 495583 (Aug. 29, 1996). *Willard* reiterates settled Texas law that borrowers are not third-party beneficiaries with standing to sue the lender's insurer on the basis of the lender's insurance policy. This has been and remains Texas law, *unless*—as a result of the Fifth Circuit's holding in this case—the parties happen to be liti-

gating in federal court instead of Texas state court. If the decision below stands, the substantive law on this issue in a Texas federal court will be directly contrary to the law in a Texas state court. This result promotes confusion, forum shopping and exposes litigants to inconsistent results.

The practical consequences of the decision below greatly concern and affect the mortgage guaranty insurance and mortgage industries. Amicus is well acquainted with these industries, including primary and secondary markets for mortgage loans. Amicus can explain the negative effects of the Fifth Circuit's opinion on previously settled business and legal relationships between the mortgage insurer and its insured lender, on the one hand, and the *risk* that the lender insures against—*the borrower*—on the other.

For these reasons, MICA respectfully requests that the Court grant this motion for leave to file the attached brief amicus curiae.

Respectfully submitted,

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BRIEF AMICUS CURIAE OF MORTGAGE INSURANCE COMPANIES OF AMERICA IN SUPPORT OF THE PETITION

STATEMENT OF INTEREST OF AMICUS CURIAE

Founded twenty-three years ago, Mortgage Insurance Companies of America ("MICA") is a trade organization whose eight corporate members and their affiliates make up the active United States private mortgage guaranty insurance industry. MICA's member companies insure millions of mortgage loans and thousands of mortgage lenders and secondary mortgage market investors nationwide. MICA's purpose is primarily educational: informing members, the mortgage lending industry and housing trade organizations of relevant legislative, regulatory and legal changes. MICA also represents the mortgage guaranty insurance industry's position on Capitol Hill.

The purpose of mortgage insurance is to protect lenders from default-related losses on conventional first mortgages made to home buyers who make down payments of less than 20 percent of the purchase price. The roots of private mortgage guaranty insurance extend back to the late 1800's when the state of New York first passed legislation authorizing the insuring of mortgages. The modern private mortgage guaranty insurance industry dates from the 1950's.

The federal government entered the mortgage insurance business in 1934 with creation of the Federal Housing Administration ("FHA"). By guaranteeing full repayment to lenders if borrowers defaulted on their mortgages, the FHA program stimulated investor confidence in mortgage instruments and thereby encouraged growth of the housing markets. The FHA, Veterans Administration ("VA") and private mortgage guaranty insurers act in similar ways to protect lenders in case of borrower default. The FHA, VA and private mortgage guaranty insurers have played an important role in encouraging availability of affordable housing. Private mortgage guaranty insurance provides lenders an alternative means of insuring against borrower default. Availability of mortgage guaranty insurance to lenders plays a major role in facilitating the sale and marketability of residential mortgages to investors in the secondary market. The existence of that secondary market in turn supports expanded availability of mortgage financing necessary to further housing development.

Amicus is devoted to and has an interest in the strength and stability of the mortgage lending and mortgage guaranty insurance industries. As discussed more fully below, the Fifth Circuit's decision in this case—based on a misunderstanding of the limits *Erie* imposes under our federal system on the ability of a federal diversity court to create new state law—is not only legally incorrect, it also poses a serious threat to continued sta-

bility of the mortgage lending and mortgage guaranty insurance communities.

SUMMARY OF ARGUMENT

The Fifth Circuit's decision below violates the doctrine of *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938), and principles of federalism underlying it, creates unmanageable legal inconsistencies and has numerous adverse consequences for mortgage lenders and mortgage guaranty insurers. These negative consequences derive from the fundamental flaw in the majority opinion, i.e., the new rule that the borrower is a third-party beneficiary of the lender's policy of mortgage insurance. This flaw results from the Fifth Circuit's disregard of established, consistent Texas law in its misguided and unrestrained *Erie* analysis. This Court should grant the petition to clarify appropriate standards for an *Erie* analysis in a case such as this, and the limits *Erie* places on the ability of a federal diversity court to create new state law. The Fifth Circuit's failure to recognize any such limits in this case resulted in a new rule of law with disruptive consequences for national commercial and public policy interests. These consequences, as discussed below, are yet another reason warranting this Court's review.

ARGUMENT

I. THIS COURT SHOULD GRANT CERTIORARI TO RESOLVE THE CONFLICT OVER WHETHER A FEDERAL DIVERSITY COURT MAY CREATE A NEW STATE CAUSE OF ACTION CONTRARY TO WELL-SETTLED STATE LAW AND COMMERCIAL PRACTICE.

Texas courts have consistently held that borrowers are not third-party beneficiaries of the private mortgage insurance contract between the lender and private mortgage insurer. See *Pineda v. PMI Mortgage Ins. Co.*, 843 S.W.2d 660 (Tex.App. 1992); *Shields v. Atlantic Fin. Mortgage Corp.*, 799 S.W.2d 441 (Tex.App. 1990); and

Hunt v. Jefferson Sav. & Loan Ass'n, 756 S.W.2d 762 (Tex.App. 1988), *cert. denied*, 489 U.S. 1079 (1989). Courts in other jurisdictions considering the issue have reached the same result.[1]

These state law decisions reflect the business reality that mortgage guaranty insurance is obtained by the lender to protect it from loss in the event the borrower defaults on the mortgage. The borrower is not the beneficiary of such a policy but the *risk or hazard* insured against. This is evident by the fact that mortgage insurers' underwriting to determine whether or not to insure a lender for a particular mortgage consists primarily of review of the potential borrower's creditworthiness, in order to determine the likelihood that the borrower may default, thus causing a loss to the insured lender and insurer.

Private mortgage guaranty insurance is an alternative to mortgage insurance provided by the FHA and VA. Like state decisions dealing with private mortgage guaranty insurance, federal decisions and legislative history pertaining to FHA insurance reflect that no legal relationship exists between the FHA [the insurer] and the borrower.[2]

Until the decision below, these reported decisions consistently defined the respective legal positions of the mortgage insurer, its insured lender and the borrower. The majority's radical departure from Texas and federal law injects chaos into these previously settled relationships. This chaos takes several forms.

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[1] See, e.g., *Twin City Fed. Sav. & Loan v. Zimmerman*, 411 N.W.2d 294 (Minn. Ct. App. 1987); *Key Pacific Mortgage, Inc. v. Industrial Indem. of Alaska*, 845 P.2d 1087 (Alaska 1993); and *Sandusky v. First Nat'l Bank of Sikeston*, 773 S.W.2d 95 (Ark. 1989).

[2] See *United States v. Neustadt*, 366 U.S. 696, 709 (1961); See also *DeRoo v. United States*, 12 Cl. Ct. 356 (1987) (no express or implied-in-fact contract existed between borrower and FHA, even where borrower allegedly relied upon FHA's issuance of conditional commitment of insurance).

The mo[illegible]ge guaranty insurance industry has never regarded the borrower as a third-party beneficiary of the insurance policy. This fact was before the trial court below in the form of expert testimony by Roger Blood, an experienced mortgage insurance consultant and commentator.[3] Mr. Blood explained:

> Based on my practical and personal experience with IMI [Investors Mortgage Insurance Company] and the mortgage insurance industry over the years, I know that the borrower is not recognized or treated as a beneficiary of the mortgage insurance policy. Mortgage insurance plainly and simply protects the lender against loss caused by the default of the borrower on the loan.

In holding that the borrower is a third-party beneficiary of the particular mortgage guaranty insurance policy at issue in this case, the Fifth Circuit has created a direct conflict of interest between the insurer's duties to its insured lender, on the one hand, and newly imposed duties to the borrower, on the other hand. Although the borrower is the lender's customer, the reality of those parties' relationship, as reflected in typical loan documents between them, is that the borrower is legally adverse to the lender. The lender is a creditor; the borrower is a debtor. The lender insures itself to protect against the borrower's default. The insurer's duties run logically and by commercial necessity to its insured, *not* to the party who is the *risk* insured *against*.

The legally adverse lender/borrower relationship is, for practical purposes, similar to the relationship between a first-party insured under an automobile liability policy and a third-party claimant to whom the first party insured may be liable. The Texas Supreme Court addressed the latter relationship in *Allstate Ins. Co. v. Watson*, 876 S.W.2d 145 (Tex. 1994), and recognized that the insurer cannot

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[3] Mr. Blood's affidavit (Docket No. 81) was offered in support of petitioner's motion for partial summary judgment.

owe coextensive duties to its insured, on the one hand, and to the third-party claimant who is adverse to its insured, on the other hand.[4]

Similarly, the borrower's interest under mortgage guaranty policy provisions are directly adverse to the interest of the insured lender. For example, under typical policy provisions, including those in the policy at issue in this case, the lender has certain rights to file a claim and receive a claim payment, subject to policy conditions. In that regard, the lender is typically required to foreclose on and be in a position to deliver marketable title to the property to the insurer. These requirements directly conflict with the defaulted borrower's interests in avoiding a foreclosure and maintaining ownership and possession of the property.

Another example of conflict between the insured lender's interests and those of the defaulted borrower arises in the context of a pre-approved sale of the real estate. In mitigating loss, mortgage guaranty insurers are frequently asked by lenders to approve a sale of the secured property by the defaulted borrower to an approved buyer, in lieu of an actual foreclosure by the lender. Particularly in circumstances in which the market value of the secured property has declined since origination of the loan, the borrower is frequently requested to contribute cash toward the requested sale price. In these circumstances, the amount of the lender's loss and the amount the insurer

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[4] That court stated:

> Recognizing concomitant and coextensive duties under art. 21.21 [of the Texas Ins. Code] to third party claimants, parties adverse to the insured, necessarily compromise the duties the insurer owes to its insured. In fact, the logical result of permitting a separate and direct cause of action in favor of third party claimants allows third parties to sue for unfair claim settlement practices *even though the insured has no claim for an unfair claim settlement practice.*

876 S.W.2d at 150.

must pay the lender are directly affected by how much, if anything, the defaulted borrower is willing to contribute toward the pre-approved sales price in order to avoid a foreclosure. The more the borrower is willing to contribute, the smaller the lender's and insurer's losses will be as a result of the borrower's default. However, a defaulted borrower may perceive it to be in his or her best economic interest to contribute nothing, resulting in an increased loss to the lender. This example again reflects the legally adverse interests between the insured lender and the borrower by virtue of their creditor/debtor relationship.

Although the Fifth Circuit has held that the borrower is a third-party beneficiary of a particular policy, the court provides no guidance about the nature and extent of any alleged duties that the insurer may owe this purported beneficiary. For example, does the insurer have a duty to provide notice to the defaulted borrower of various aspects of processing the lender's claim under the policy? This and similar commercial and legal questions are not rhetorical, but will arise hundreds of times daily in operation of the mortgage lending and mortgage guaranty insurance industries if the decision below is left undisturbed.

The Texas Supreme Court expressly has refused to impose these conflicting duties on an insurer [5]; and yet, under the alleged rubric of *Allstate*, the Fifth Circuit has done

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[5] Subsequent to its holding in *Allstate*, the Texas Supreme Court also recently held in *Maryland Ins. Co. v. Head Indust. Coatings & Servs., Inc., et al.*, 40 Tex. Sup. Ct. J. 49 (Oct. 18, 1996) (*per curiam*) that an insurance carrier does not owe a duty of good faith and fair dealing to investigate and defend third party claims against its insured. Recognizing that an insured is protected against the insurer's refusal to defend or mishandling of a third-party claim by his contractual and other rights, the court concluded that imposing an additional duty of good faith and fair dealing on insurers is unnecessary and inappropriate. This opinion demonstrates that the Texas Supreme Court is *not* inclined to impose additional duties on an insurer, contrary to the Fifth Circuit's "*Erie* guess" in the *Palma* decision.

just the opposite. The illogical result is that the party legally adverse to the insured lender has now been given rights under the policy by the Fifth Circuit. This conclusion is legally and commercially untenable.

The Fifth Circuit's spontaneous creation of "new" Texas law results in mutually exclusive legal rules regarding the mortgage guaranty insurance contract. As petitioner discusses, Pet. at 20, Texas litigants now have two sets of inconsistent rules regarding the mortgage insurance contract: if the parties are in state court, the borrower is *not* a third-party beneficiary of the contract and has no standing under the Texas Insurance Code to sue the mortgage insurer; if the parties are in federal court, the contrary *Palma* rules would apply. This conflict exposes litigants to precisely the sort of inconsistent results that the proper application of *Erie* was designed to avoid. These conflicting rules also make it impossible for the lender and insurer to conform their business practices to consistent legal standards. Such conflicting rules create uncertainty among lenders, mortgage insurers and investors in the secondary mortgage market as to what rules apply to insured loans originated in Texas. The intolerable result is that the parties will only know which set of rules will *finally* apply once litigation ensues and the forum has been selected.

As petitioner demonstrates, division among the circuits as to how to apply *Erie* requires guidance and clarification from this Court. The decision below is a prime example of the unfortunate consequences of lack of judicial restraint on the part of federal diversity courts when it comes to creating new state law. The inaccuracy of the Fifth Circuit's "*Erie* guess" was confirmed when the Tyler, Texas Court of Appeals decided *First Am. Title Ins. Co. v. Willard*, No. 12-93-00290-CV, 1996 WL 495583 (Tex. App. August 29, 1996), holding that a mortgage borrower lacked standing to sue the lender's title insurer for a claim based on the title insurance policy. This result is entirely

consistent with Texas cases dealing with mortgage guaranty insurance, on which the industry has relied, but which the Fifth Circuit has rejected in its result-oriented decision.

Amicus has been advised that on November 5, 1996, the Fifth Circuit denied petitioner's motion for recall of the mandate and motions for leave to file a second petition for panel rehearing and a second suggestion for rehearing en banc. Petitioner had filed these motions to bring the intervening *Willard* decision to the attention of the Fifth Circuit, following the procedure adopted by petitioners in *Huddleston v. Dwyer,* 322 U.S. 232 (1944); *Exxon Co., U.S.A. v. Banque de Paris et des Pays-Bas,* 488 U.S. 920 (1988); and *National Union Fire Ins. Co. v. American Medical International, Inc.,* 116 S. Ct. 510 (1995). The Fifth Circuit's denial of the motions now places this case on all fours with *Huddleston, Exxon,* and *National Union.* In each of those cases, this Court granted certiorari, vacated the judgment below, and remanded for further consideration in light of the intervening state court decision. The Court should at the very least do the same here, if it is unwilling to grant certiorari to review the merits at this time.

The decision below also ignored other clear Texas precedent regarding the third-party beneficiary issue. Under Texas law, the intentions of the contracting parties [lender and mortgage guaranty insurer] control in determining whether or not the borrower is a third-party beneficiary. *See Corpus Christi Bank & Trust v. Smith,* 525 S.W.2d 501 (Tex. 1975). The law presumes that those parties contracted only for their own interests. Any doubt concerning whether or not the mortgage insurer and lender intended to benefit the borrower must be construed against the borrower as the alleged beneficiary. *See MJR Corp. v. B & B Vending Co.,* 760 S.W.2d 4, 8 (Tex.App. 1988).

Thus, the Fifth Circuit ignored settled Texas law pertaining not only to mortgage guaranty insurance in par-

ticular, but also the criteria for determining third-party beneficiary status in general.

II. THIS COURT SHOULD GRANT CERTIORARI BECAUSE THE FIFTH CIRCUIT'S OPINION ENCOURAGES BORROWER DEFAULT AND UNDERMINES STABILITY OF THE SECONDARY MARKET IN RESIDENTIAL MORTGAGES

As discussed on pages 5-8, bestowing third-party beneficiary status on the borrower will cause confusion generally in the relationship between the mortgage lender and the mortgage guaranty insurer. Allowing the borrower to interpret and enforce specific policy provisions also will lead to other results unintended by the lender and insurer and unexpected in the secondary market. For example, the Fifth Circuit adopted the borrower's argument pertaining to foreclosure bidding requirements in the policy and the assignment of deficiency rights by the lender. In so holding, the Fifth Circuit's decision effectively encourages borrower default, which will directly weaken the secondary mortgage market. If, as the Fifth Circuit has held, the borrower is a third-party beneficiary of this particular insurance policy and is entitled to enforce policy provisions, borrowers will likely believe that they can default without the threat of personal liability, to the detriment of the lender and insurer.

A. Increased Borrower Default

In the trial court, Palma argued that the lender was required by the particular mortgage guaranty insurance policy in question to bid the full amount due to the lender under the policy ("full-debt bid argument"). Taken to its logical end, this means that at the insistence of the borrower, the lender would be required to either forego or extinguish a deficiency by bidding the full amount of the debt at foreclosure.

The trial court rejected the "full-debt bid argument." The Fifth Circuit, however, appears to have adopted the argument by holding that the borrower had standing as a policy beneficiary to require the lender to bid either (1) the full amount of the balance due on the note, or (2) no less than twenty-five percent of the balance due on the note.[6] In addition to creating confusion regarding foreclosure bidding requirements, the decision below also confuses the borrower's role in relation to mortgage guaranty insurance.

In practical effect, the majority's opinion empowers the *borrower*—the party whose conduct is the *hazard* or *risk* insured *against*—to not only control the risk by deciding whether to pay, but also to avoid the consequences of her default by insisting that the lender extinguish any possible deficiency by bidding the full amount of the debt at foreclosure. This result conflicts with long-standing Texas law, under which lenders have the right to preserve and assert deficiencies after a borrower defaults on a purchase money mortgage.[7]

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[6] This holding is confusing and internally inconsistent. The Fifth Circuit provides no guidance as to whether or not the borrower can always insist that the lender bid the full amount of the debt or whether or under what circumstances the lender may bid less.

[7] See generally, Tex. Prop. Code Ann. § 51.002 (Vernon 1995); *Guerra v. Raymondville Bank of Texas*, 791 S.W.2d 212 (Tex. App. 1990); see also Tex. Prop. Code Ann. § 41.001(b)(1) (Vernon Supp. 1995). As further evidence that the borrower is not a third-party beneficiary of the mortgage insurance policy, the Texas legislature amended § 51.003 of the Tex. Prop. Code in 1991 to require a lender to credit the account of the borrower for any money received by the lender from a private mortgage guaranty insurer prior to the lender bringing an action for any deficiency owed by the borrower. The credit required by the statute specifically does not apply to the exercise by a private mortgage guaranty insurer of its subrogation rights against a borrower or other person liable for any deficiency.

Texas has made a determination that allowing deficiencies promotes an important policy by deterring borrower default. Without the possibility of personal liability for their mortgage obligations, defaulting borrowers have a distinctly reduced incentive to pay the mortgage which will likely lead to increased borrower default. As testimony before the trial court below demonstrated, an increase in borrower default will have a serious impact on the secondary mortgage market.

B. The Effect on the Secondary Market

By the mid-1980's, the residential mortgage market had become fragmented. Lenders who originated loans typically did not retain in their portfolio most of the loans they made. Instead, these originating lenders sold these loans into a national mortgage market,[8] often referred to as "the secondary market." The secondary market in residential mortgages is dominated by two large federally-created entities, Fannie Mae and Freddie Mac. Fannie Mae, a congressionally chartered, shareholder owned company, is the largest United States investor in residential mortgages and the largest issuer of securities after the U.S. Treasury. Generally, lenders require mortgage insurance when borrowers make down payments of less than 20 percent of the purchase price of a home because statutes establishing Fannie Mae and Freddie Mac provide that such entities must require mortgage insurance for such loans, unless the originating lender retains an interest of at least 10 percent in the mortgage or is contractually obligated to repurchase the mortgage if the borrower does not pay.[9]

Lenders and mortgage insurers know from experience that borrower attitudes about paying their mortgage directly affect stability of the secondary market. For ex-

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[8] Blood affidavit at 6.

[9] See 12 U.S.C. § 1454(a)(2) [Freddie Mac]; and 12 U.S.C. § 1717(b)(2) [Fannie Mae].

ample, by the mid-1980's, lenders and mortgage insurers recognized that a growing number of delinquent borrowers were able, but less than willing, to make their mortgage payments.[10] As a result, pursuit of deficiency judgments by lenders and mortgage insurers, where permissible, became even more important. The facts of this case illustrate the point. See Pet. at 4, 5.

Expert testimony before the trial court demonstrated the importance to lenders, investors in the secondary market and mortgage insurers of pursuing deficiencies. Caryl S. Bernstein, former General Counsel of Fannie Mae, testified that:

> Fannie Mae has a history of pursuing both owner/occupant and investor defaulting borrowers for the collection of deficiencies. Fannie Mae and other members of the lending community believed that the possibility of subjecting borrowers to deficiency judgments could operate as a significant deterrent to default. Additionally, the lending and mortgage insurance community realized that the recovery of deficiencies from borrowers, regardless of their occupancy status, was an effective loss mitigation technique.
>
> The effect of Ms. Palma's [full debt bid] argument would be to transform the mortgage Note that she signed into a nonrecourse Note, when in fact, the Note was a full recourse Note. This result would not be in the best interest of lenders, including Fannie Mae, mortgage insurers, nor the public. Ms. Palma's approach would confer a special benefit upon people who make low down payments when purchasing homes [so that mortgage insurance would be required], while those who make higher down payments [so that mortgage insurance would not be required] would continue to be subject to deficiency judgments and otherwise be treated as having made

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[10] Blood affidavit at 7.

> full recourse Notes. *There can be no public policy reason for treating those who borrow a higher percentage of their home's value more favorably than those who put more of their own money into their homes.*[11] (emphasis added)

Ms. Bernstein further testified that pursuit of deficiency judgments contributes to the financial stability of lenders, mortgage insurers and taxpayers, especially when insured depository institutions are involved.[12]

C. Assignment of Deficiency Rights

The Fifth Circuit further componded its error of bestowing third-party beneficiary status on the borrower by adopting the borrower's interpretation of the policy. For example, the majority concludes that the assignment between petitioner and its insured lender is illegal. Contrary to the language of art. 21.21A of the Texas Insurance Code, an obscure provision with no relevant annotated case law, other Texas law and an attorney general's opinion permit an insurer and its insured to modify by agreement matters pertaining to the loss. See *Hartford Fire Ins. Co. v. Galveston, H. & S.A. Ry. Co.*, 239 S.W. 919 (Tex. 1922); and Texas Attorney General Opinion No. JM-218-1984.

Similarly, Ms. Bernstein testified that Fannie Mae regularly assigns its contractual rights to pursue borrowers to mortgage insurers and others, and believes it has the right to do so.[13] The Fifth Circuit's opinion thus impugns the practice of assignment of deficiency rights on insured residential loans originated in Texas, a practice widely

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[11] Docket No. 81 at 11. Ms. Bernstein's affidavit was before the trial court in support of petitioner's motion for partial summary judgment.

[12] *Id.* at 12.

[13] *Id.* at 9.

used in the secondary market to deter borrower defaults and mitigate losses.

Assignments of lenders' claims against defaulted borrowers are also widely used to pursue deficiencies arising out of loans insured by FHA. The National Housing Act expressly provides that the Secretary of Housing and Urban Development has the power to pursue claims against borrowers assigned by lenders. 12 U.S.C. § 1710 (g). To effectuate such power, the statute also requires that a lender who forecloses and takes possession of the mortgaged property after a borrower's default must assign to the Secretary "all claims of the mortgagee against the borrower . . ., arising out of the mortgage transaction or foreclosure proceedings. . . ." 12 U.S.C. § 1710(a). Assignment of claims against defaulted borrowers is thus a commonly used and important tool to discourage borrower default. The Fifth Circuit's pronouncement that such a practice is illegal is misguided and legally incorrect.

In its zeal to fashion new rights for the borrower, the Fifth Circuit's opinion reduces borrowers' incentives to pay their mortgages, creates untenable and conflicting rules of law and imposes conflicting duties on the insurer. All of these results are detrimental to the mortgage lending and mortgage guaranty insurance industries and ultimately to those persons seeking affordable housing.

CONCLUSION

For the foregoing reasons, and those in the petition, this Court should grant the petition and reverse the decision below; alternatively, this Court should grant the petition, vacate the judgment and either certify the state law question to the Texas Supreme Court or remand to the Fifth Circuit for further determination in light of an intervening Texas intermediate appellate decision.

Respectfully submitted,

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